

# The Long Run?

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**LOW INTEREST** rates are terrific if you're looking to buy a new house and, if you're a bond investor, the 25-year ride to today's low interest rates has been enjoyable, too. For 2006, though, bond buyers have painted themselves into a corner by squeezing out all the sources of return: The US Treasury yield curve is flat, thanks to demand for long-dated assets, and the yield premiums available in the credit sectors are very thin (just 50 basis points or so for corporate bonds rated AA, and about 175 basis points for the best high-yield paper).

Low rates and thin risk premiums have nowhere to go but up. This makes conventional investing difficult by threatening bond prices, but also keeps sponsors from implementing the lessons learned in the Great Unpleasantness five years ago—that leaving a substantial mismatch between the returns on a pension plan's assets and the growth in its benefits obligations threatens both its beneficiaries and its sponsor, and that the best solution available is a well-planned allocation to long-term bonds.

With important and expensive changes looming for both the accounting and funding rules for US defined benefit plans, there is plenty of discussion of the need for liability-directed investment—and, in response, fixed-income managers are sprucing up their old long-duration offerings, or developing new ones. “If the increased regulation comes,” says David Thompson, chief investment officer at Dwight Asset Management, Burlington, Vermont, “the need for long-duration strategies could be huge, so a lot of firms are said to be growing a long-duration asset management style.”

In the United Kingdom, rule changes on

<b>Median Swell</b>			
<i>Returns for the median managers of core, core plus, and long duration</i>			
	Annualized Returns		
	One year	Three years	Five years
Lehman Aggregate	2.43%	3.62%	5.87%
<b>EXCESS RETURN OF:</b>			
Median active manager—core	0.28%	0.27%	0.24%
Median active manager—core plus	0.49%	1.49%	0.57%
Lehman Long Government—credit	5.33%	6.58%	8.32%
<b>EXCESS RETURN OF:</b>			
Median active manager—long duration	0.50%	0.24%	0.30%
<i>Source: eVestment Alliance manager return database</i>			

funding and pension valuation in sponsors' financial statements imposed by FRS 17 were phased in starting in June of 2001, were fully adopted by June of 2003, and have clearly caused a shift in investment. The shift from equities to bonds is massive, say Connecticut-based researchers Greenwich Associates. “Domestic equity of UK pension funds has fallen by a striking 13% since 2000,” including a 5% drop in 2003 and 2004, reports consultant Chris McNickle. He adds that fixed-income allocations grew from about 21% of UK plan assets in 2000 to 30% in 2004.

Institutions started to move to long-duration strategies in 2005, according to Casey, Quirk & Associates, consultants to the money management industry, based in Darien, Connecticut. The firm reports a trailing 12-month inflow to long duration of \$13 billion in the third quarter, up sharply from quarterly 12-month flows hovering between zero and \$6 billion for the preceding two

years. Yariv Itah, senior consultant with CQ&A, notes that, in the past, the new cash flows have gone to traditional long-duration managers, but recent figures suggest that a good part of the business also has started accruing to the new generation of firms that devise long-duration exposures from derivative overlays augmented by hedge funds or other sources of alpha.

However, \$13 billion represents just a grain of sand in the multi-trillion-dollar pension desert, and the volume of new business in long duration is disappointing to fixed-income managers. “We’ve heard a lot of talk about clients managing to their liabilities, by going with longer bonds or derivatives overlays on core strategies but, as for actually putting the programs in place, it seems the market is stuck,” observes Paula Ryan, executive vice president and director of marketing for Hartford Investment Management Co., a subsidiary of The Hartford Financial Services Group, Inc.

# Head of the Class

## MANAGER PROFILES

### Dwight Asset Management, Burlington, Vermont

\$56.5 billion in managed assets, in fixed income, stable value, and insurance company general accounts

CORE FIXED INCOME	3-YEAR	PERCENTILE	5-YEAR	PERCENTILE
Annualized excess return	1.61%	1	1.05%	4
Information ratio	2.16	-	1.16	-

*Comparisons against Lehman Aggregate Bond Index as of 12/05*

Source: eVestment Alliance

"We're able to think more clearly than most managers, thanks to the clean Vermont air," jests David Thompson, chief investment officer, based a few blocks' walk from Lake Champlain in Burlington. Total firm assets stand at \$56 billion, up from \$16 billion in 2000. The firm based its initial growth on guaranteed investment contracts, but has turned lately to managing insurance company general accounts and conventional total return fixed-income portfolios for pension funds (\$22 billion). Dwight's staff of 26 investment professionals includes 10 senior credit analysts, and 10 specialists who manage subportfolios oriented by bond market sectors and issuers' industries.

"We made money in security selection and sector rotation in 2005—that's what we're best at," Thompson relates. "We avoided the credit disasters in 2002, and then took advantage of them in 2003, mostly in the investment-grade corporate market. We use high-quality structured products, like asset-backed and commercial mortgage-backed securities, and opportunistically use credit exposure to strong high yield to add extra return."

### Brandes Partners, San Diego, California

Total AUM \$102 billion in equity and fixed income

CORE FIXED INCOME	3-YEAR	PERCENTILE	5-YEAR	PERCENTILE
Annualized excess return	1.45%	1	0.64%	15
Information ratio	1.24	-	0.43	-

*Comparisons against Lehman Aggregate Bond Index as of 12/05*

Source: eVestment Alliance

Brandes Partners is well-known for its value equity products and, in the past five years, has carried over its analytical style to fixed income, having acquired Wisconsin-based Hilltop Capital Management in July 1999. The offering includes core, core plus, and intermediate strategies, plus a successful "corporate-focused" product entirely made up of investment-grade corporates. "We offer a disciplined process that is not like the usual suspects of BlackRock, PIMCO, and Western," reports Cliff Schireson, co-head of the firm's fixed-income group. "We are bottom-up bond pickers, rather than looking for relative value across sectors." Four full-time bond analysts identify undervalued bond opportunities, which are then reviewed and valued by a bond investment committee. "We have the benefit of a top-notch credit research group, and can apply much of Brandes' conservative, value-style equity work," Schireson explains.

Unlike the giant firms, "Our portfolios are 101% bonds, with no derivatives," he adds, "although, in some cases, we add derivatives in a specific program—for instance, to extend a particular client's duration." The style is neutral with respect to the benchmark yield

curve, but does allow for deviation from the index duration by 10%. "We've been short duration for a while, although this might be the year we take that back to neutral."

### Sovereign Asset Management, Boston, Massachusetts

Total AUM: \$25 billion in fixed income and equity

CORE FIXED INCOME	3-YEAR	PERCENTILE	5-YEAR	PERCENTILE
Annualized excess return	1.93%	1	0.74%	13
Information ratio	2.07		0.49	

*Comparisons against Lehman Aggregate Bond Index as of 12/05*

Source: eVestment Alliance

"We've had a team in place for 10 years, and have shown that we can make money in lots of different ways," states Barry Evans, head of fixed income at Sovereign, which is the US institutional money management arm of John Hancock's parent, Manulife Financial Corporation.

Evans credits the experience of his team for adding return in an environment of tight spreads in the bond market: "Every analyst is seasoned, and covers an entire sector from investment grade to high yield, giving us more insights for security selection in a core-plus strategy." He cites the example of rising oil prices: "Our team's ideas led us to buy Russian bonds, where most of the revenues are coming from oil. A smart way to play it now, when most of the market already reflects the impact of oil, is in Canadian dollar bonds, where the trade balance will be improving. That's becoming a fashionable trade, but we were there a year and half ago."

### STW Fixed Income Management, Carpinteria, California

Total AUM: \$12 billion in fixed income

CORE FIXED INCOME	3-YEAR	PERCENTILE	5-YEAR	PERCENTILE
Annualized excess return	0.90%	13	1.30%	1
Information ratio	0.86	-	0.89	-

*Comparisons against Lehman Aggregate Bond Index as of 12/05*

Source: eVestment Alliance

Billy Williams, the founder of STW, cherishes the freedom of a small, independent, specialist firm with a value bent, and not having to fill every need of the market. "We're not a core-plus manager—we hold no junk, no foreign currency, no emerging markets." He also enjoys being a truly active investor: "We're part of the old tradition of buying cheap bonds, and selling the expensive ones. We're not overweight some things and underweight others—15 years ago, that was called enhanced indexing." STW offers three products to the US market—short, long, and core fixed income—and all are highly ranked.

To address the flat yield curve and thin credit premiums, "We don't own a single long corporate, and we haven't since last year," Williams explains. "In the longer part of the portfolio, we have only Treasuries and municipal bonds. The only credit assets we have are short and high quality—AAA asset-backeds—no mortgages or GSEs. Short corporates, long Treasuries, and munis. What a clean, boring portfolio," he says.

## You Can't Get There from Here

"Sponsors and consultants have yet to get their hands on how long duration works and the best way to go forward," says Dwight Asset Management's Thompson. At Brandes Partners Fixed Income Group, however, two clients are taking a core-satellite approach to matching their liabilities with bonds, reports Cliff Schireson, co-head of the unit. "At the center of the allocation would be long duration, invested in Treasuries where you won't get much alpha, and the satellite strategies would have shorter durations, and are intended to provide more alpha, [through exposure to credit risk or for eign currency]."

Leaving aside the complexity of the investment, sponsors have balked at moving their plans to long-duration strategies at present, due to the opportunity cost. They would lock in long-term yields at near-record lows and, due to the current flat yield curve, not receive any premium to invest long. "If a plan buys a lot of long bonds at 4.5%, and rates are up at 6% in 18 months, it won't look like a good decision," explains Marko Komarynsky, a consultant in the Chicago office of Watson Wyatt Worldwide. "You will have had insurance, but you could have done it more cheaply by waiting for higher rates." Accordingly, many sponsors have chosen to wait.

Recent returns on bond accounts—in single digits for both intermediate and long-duration bonds—have not provided sponsors with much encouragement.

Active management has beaten the index by about 30 basis points annually in core, and between 50 and 150 basis points in core-plus strategies. Excess returns earned by first quartile core and core-plus managers added a further 30 to 60 basis points to the median return. The median long-duration manager has beaten his index by 25 to 50 basis points for the last five years, while the first quartile long-duration manager added just 35 basis points annually over the last five years.

## A Game of Inches

What do current interest rate conditions—yields that are low and flat to the horizon, with thin premiums for taking on the risk of credit or emerging markets—suggest for sponsors' bond core and core-plus returns in the future? Billy Williams, head of STW Fixed Income Management in Carpinteria, California, points out that many managers are using "yield tilt" techniques, grabbing yield wherever they can in both high yield and investment grade, without straying too far from the index. "That will work if spreads don't widen," he explains, "but they can't stay this narrow forever." When they do widen, Williams expects the "plus" tactics to undermine core-plus strategies—as they did in 1999 and 2000—"and the guys who have done the best in the last year or two because of those yield tilts will suddenly underperform [the more conservative core universe]."

At Hartford Investment Management Co., senior portfolio manager Nasri Tou-toungi sees future returns in terms of the macro picture. "There is a lot of liquidity sloshing around," he says. "Petrodollars and the big current account surpluses from emerging markets countries are trying to find a home. That's created an environment of low return that we expect to continue, so core and core-plus accounts will show returns of about 4% to 5% this year and next."

"There could be a large surprise—that the yield curve steepens, due to an inflation premium added to the long bond," says Barry Evans, head of fixed income at Sovereign Asset Management in Boston, an affiliate of John Hancock Insurance. "Here are a couple reasons," he adds. "Can we put a higher inflation premium in the long bond from higher oil prices? Quite possibly, and the odds are that wages are still moving up"—US employment costs rose 3.1% for 2005, says the Bureau of Labor Statistics—"so you could drive inflation up that way.

"The consensus opinion regarding the long end of the yield curve is that there's little risk of higher rates," due to high demand for long bonds from oil exporters and strong emerging market economies, but Evans concludes: "That consensus is what I want to question the most."

—John Keefe